THE INDONESIAN CRISIS OF 1997-1999 AND THE WAY OUT: WHAT ARE THE LESSONS OF HISTORY?[1]

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Professor Kindleberger began his well-known book, **Manias, Panics and Crashes,** with the observation that "there is hardly a more conventional subject in economic literature than financial crises" (Kindleberger 1989: 3). He went on to point out that few books appeared on the subject in the decades following 1945 because at least until the mid-1970s, recessions were mild in the major western economies, and major depressions were thought to be a thing of the past. Kindleberger pointed out that the study of financial crises receives a tremendous boost when crises erupt, but tends to wane in periods of sustained economic growth. Such a boost was given in many parts of the world in the 1930s, and indeed that decade's rich lode of data continues to be mined by scholars in many parts of the world, and shows little sign of exhaustion. The "Great Depression" literature continues to expand, not just with reference to the North Atlantic economies, but also in the context of Asia, Africa and Latin America[2]. The advent of two serious recessions in the western economies in the early 1980s and the early 1990s, together with the spectacular stock market crash of October 1987, and the "third world" (mainly Latin American) debt crisis which rumbled on through much of the 1980s, together gave rise to a new spate of crisis literature. Kindleberger in the preface to the revised edition of his book pointed out that "the contemporary world is very much on my mind as I work on my revision in the summer of 1988; news about failing banks and insolvent institutions breaks almost daily"

But by and large, the crisis literature of the 1980s, and the early part of the 1990s ignored Asia for the rather obvious reason that the major Asian economies, from the 1960s right through to July 1997, seemed almost impervious to economic

[1]This is a revised version of a paper originally prepared for the conference "Crisis and Continuity: Indonesian Economy in the Twentiath Century", Gadjah Mada University, Yogyakarta, July 1999.

[2]Rothermund (1996) examines the depression in a global context. A forthcoming volume edited by Peter Boomgard and Ian Brown looks specifically at the impact of the 1930s world crisis on South East Asia.

fluctuations in other parts of the world. Certainly in Japan, the bursting of the asset bubble in the early 1990s ushered in a period of economic stagnation from which the economy has yet to emerge. But in Hong Kong, Taiwan and China, in South Korea and in the main ASEAN economies the engine of economic growth appeared to be beating faster than ever in the decade from 1985 to 1995. Taken as a group, the developing economies of East and South East Asia grew at over seven per cent per annum in per capita terms over the decade from 1985 to 1995, a much faster growth rate than any other major region in the world (World Bank 1997: 215). In 1996 some warning signals emerged, especially in Thailand, but few observers expected that economy to experience anything more than a slowdown in the frenetic pace of economic growth that had occurred in the decade up to 1995. Virtually no one, as far as I know, predicted that a slowdown in Thailand would have a serious impact on growth in other parts of the region[3].

In early July 1997, the Thai authorities were forced to bow to the inevitable and allow the baht to float against the dollar and other currencies. The rest, of course, is already history. The impact of the Great Asian Crisis on the literature of financial crises has already been prodigious, as Kindleberger's dictum would have predicted. The full gamut of late 20th century communication technologies has been enlisted by pundits of all persuasions to put forward their views on the origins of the crisis, and the lessons it offers. Most of us cannot keep up with the literature now pouring out in the conventional formats of journal article and scholarly monograph, let alone what is emerging on the internet. Truly this crisis has had something for everyone. Those economists who made their reputations analysing financial crises in Latin America and elsewhere now have some fascinating new case studies on which to further hone their theoretical and econometric tools. Those who made reputations criticising "mainstream" explanations of the Asian miracle now have some powerful new ammunition which they can aim at their more conventional colleagues, at the Bretton Woods institutions, and indeed at global capitalism itself. The workshops, conferences, monographs and of course the web pages seem likely to go on proliferating for some years to come.

In this paper I do not propose to attempt a full survey of the crisis literature, even in the Indonesian context. Instead, I will try to place the dramatic economic events of the past three years in a rather broader comparative and historical context. I will argue that it is only by putting the current crisis in a longer term

[3]A comparison of macroeconomics indicators in South Korea, Thailand, Malaysia, Indonesia and the Philippines with those in Mexico prior to the 1994 crisis was given in"Emerging Asia's Sombre Era", *Economist*, August 24, 1996, pp. 67-8. A literature on "early warning signals" has developed since the crisis: see for example Goldstein (1999) and Kenward (1999). Both these writers agree that in the Indonesian case the usual macroeconomic early warning signals of a crisis were not giving cause for alarm.

perspective that we can evaluate the many policy lessons which are already being drawn, with varying degrees of boldness, by a range of observers, many of whom have only a slender grasp of recent South East Asian economic history. Because the economic crisis in Indonesia has brought about such dramatic political changes, changes which no one could have predicted two years ago, passions are running very high on many policy issues. This is understandable, but putting matters in a comparative historical perspective does at least allow us to look at some of these policy issues in a more detached, cooler, manner, and hopefully to draw some useful lessons for the challenging times ahead. But before I embark on the history, let me review what seem to me to be the main consequences of the crisis for the Indonesian economy.

What have been the effects of the crisis on the Indonesian economy?

In mid-1998, a year after the baht was devalued, it had already become clear that the Indonesian economy had been more severely battered by the crisis than any other in the Asian region. The rupiah, which was trading at around 2,500 to the US dollar in June 1997, a rate which was little changed from the previous June, had fallen to around 14,850 to the dollar by June 1998 (*Far Eastern Economic Review*, June 26, 1997, p. 74, July 9, 1998, p. 82). The June 1998 rate in fact reflected a recovery from the low point reached in late January 1998 of 17,000 to the dollar. The impact of the devaluation was most serious for those firms producing non-traded goods which had contracted large foreign debts in the latter part of the 1980s and early 1990s: by mid-1998 it was clear that the extent of private sector foreign debt was much larger than most observers (and indeed the government) had realised, and that many heavily indebted companies were simply unable to generate sufficient rupiah incomes to meet their debt service obligations. They were in effect bankrupt. Indeed they had contributed to their own bankruptcy by rushing to buy rupiah in the latter part of 1997. When the central bank refused to defend the rupiah by selling foreign exchange reserves, the steep slide in the value of the rupiah was a foregone conclusion.

The devaluation did of course benefit producers of traded goods, and even those which had substantial foreign borrowings were able to service them if they could maintain a steady flow of foreign exchange earnings. Many millions of smallholder producers of agricultural products initially enjoyed a substantial increase in their rupiah incomes, even allowing for the impact of the severe drought on production[4]. But the non-traded goods sectors, such as construction

[4]There were signs by mid-1999 that the initial improvement in the terms of trade for farmers in provinces outside Java was being eroded by the rapid increase in the cost of living. Booth (1999) gives more detail on this.

and trade were severely affected. In the cities consumer confidence collapsed as more and more companies faced insolvency, and wholesale and retail trade suffered further as a result. It was contraction in these sectors of the economy together with financial services which accounted for much of the contraction in GDP in 1998 (of an estimated 13-14 per cent). The non-oil manufacturing sector was also damaged by declining consumer demand, and foreign reluctance to continue doing business with Indonesian firms. This, combined with the collapse of the banking system, made exporting far more difficult even for firms which had built up extensive client networks abroad before the crash[5].

The likely course of per capita GDP between 1997 and 2000 is shown in Table 1: over the two years from 1997 to 1999 a real decline of around 16 per cent in predicted. This is certainly a very sharp decline over such a short time. The series produced by van der Eng (1992) indicated that between 1929 and 1934 (the trough of the depression of the 1930s) per capita GDP fell in real terms by slightly less than 17 per cent so the contraction between 1997 and 1999 is almost as great, and occurred over a shorter space of time. Although per capita GDP declined for much of the 1960s, the annual contractions, when they occurred, were never more than two or three per cent. So it seems fairly safe to claim that the per capita GDP contraction which took place in Indonesia at the century's end has been more severe than at any earlier period in the century, with the probable exception of the period of the Japanese occupation, and the ensuing independence struggle[6].

It has been argued that the contraction in Indonesian GDP in 1998 was without precedent in recent economic history. I suspect that argument may turn out to be incorrect, especially if we look not just change over a single year but also over a period of two to three years. Diaz-Alejandro (1985: 378) pointed out that real GDP fell in Chile by 15 per cent between 1981 and 1983, and 14 per cent in Uruguay between 1980 and 1993. The available data indicate that the real GDP decline in Indonesia between 1997 and 1999 was around 14 per cent which is slightly less bad than in the worst affected South American economies in the early 1980s. Diaz-Alejandro argued that the severe contractions in Chile and elsewhere were the results of both unfavourable external circumstances and "less than optimal domestic policies". As I will argue below, my view is that failures in domestic policy-making were crucial in the Indonesian crisis, and that external factors including the behaviour of the IMF, were of secondary importance.

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[5]Booth (1999) discusses the performance of non-oil exports since the crisis began. It appears that for some categories, volume response has been quite robust but prices have dropped, leading to falls in dollar earnings.

[6]The extent of the GDP decline between 1941 and 1945 remains a matter of some controversy. Van der Eng's series indicates that per capita GDP in 1945 was less than half that in 1941 which seems implausible to me, but there can be little doubt that the decline was considerable, and the recovery prolonged.

Table 1
Trends in Real Per Capita GDP and
Real Per Capita Private Consumption Expenditures, 1993-2000 [a]
(Rp 000 per capita; 1993 prices)

Year	Per capita GDP	Percapita private consumption expenditures
1993	1744	1020
1994	1845	1082
1995	1965	1200
1996	2089	1309
1997	2153	1358
1998	1843	1293
1999	1814	1273
2000	1822	1278

a GDP estimates for 1999 and 2000 estimated on the assumption that real GDP will stay constant in 1999, and grow by two per cent in 2000. The same assumptions have been made about private consumption expenditures. Population growth is estimated to be 1.57 per cent per annum between 1997 and 2000.
Sources: CBS (1998) with further data from the CBS website.

It is also important to note that while per capita GDP is projected to fall by over 15 per cent between 1997 and 2000, the decline in per capita consumption expenditures will be rather lower (Table 1). In other words the severe GDP contraction will have a more adverse effect, at least in the short run, on the investment component of national expenditure than on the consumption component[7]. In fact the preliminary data from the Central Board of Statistics shows that the investment component of GDP in 1998 has contracted by almost 41 per cent (Central Board of Statistics 1998: Table 8). Thus in 1998 expenditures on gross fixed capital formation were only 22 per cent of GDP compared with 32 per cent in the previous year. The much sharper fall in investment than in consumption expenditures has important implications for estimates of poverty because it is changes in consumption expenditures rather than total GDP which determine changes in the incidence of poverty. The projections in Table 1 indicate that real per capita consumption expenditures will be lower in 2000 than in 1996, but still higher than in 1993. In that year the CBS estimate of the proportion of the

[7]Imports of goods and services fell in 1997 and 1998 far more rapidly than exports: this reflects the sharp decline in investment expenditures which are import-intensive. In 1995, imports of goods and services, as reported in the national income accounts, were around nine per cent higher than exports: by 1998 exports were slightly above imports. See Central Board of Statistics (1999: Table 2).

population below the official poverty line was 13.7 per cent. Thus the CBS estimate published in 1998 of almost 40 per cent of the population falling below the poverty line (with little change projected until 2000) seems an exaggeration[8].

But in the longer run, a contraction in investment expenditures of 40 per cent cannot but have a very damaging effect on the growth potential of the economy. Certainly it can be argued that there was some deterioration in the productivity of investment in the last years of the Soeharto era, caused at least in part by a sharp increase in speculative investment in, for example, urban real estate[9]. In 1998/99 virtually all such investment has halted, as is obvious from the many semi-completed buildings, and empty construction sites in most large urban centres. In addition there has been little or no investment in plant and machinery for the better part of two years, and budgetary problems have led to the cancellation or deferment of many government infrastructure projects. This is of course reflected in the very sharp contraction in imports. An improvement in private investment can only come with returning business confidence, and that will inevitably be a slow process. New inward flows of foreign investment will certainly help to restore confidence, but it is important to bear in mind that FDI only accounted for quite a small part of total investment expenditures in the 1980s and early 1990s (Yoshida et al., 1994: Table 4.4). Given that in the past domestic private investors accounted for a large part of total investment in Indonesia, a rapid recovery in investment expenditure can only come about when domestic entrepreneurs, including of course the Chinese, again feel confident about business conditions.

What then can the new government which will emerge in the latter part of 1999 do to restore business confidence? I would like to make some suggestions, based on what seem to me to be the lessons both of Indonesia's economic history over the twentieth century, and of financial crises in other parts of the world. In my view many of the policy prescriptions which are being discussed at the present time ignore these lessons, and thus there is a very real danger that the new government may repeat old mistakes, committed not just by previous regimes in Indonesia but by governments and regulatory institutions in other parts of the world struggling with the consequences of financial crises. That would be a tragedy and inflict yet more suffering on a population which has already had to endure a sharp reversal in its economic fortunes. Before examining the policy options confronting Indonesia, let us briefly review the some of the crisis literature from other countries and earlier times.

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[8]For more on the various estimates which have been made of the likely impact of the crisis on poverty and living standards, see Booth (1999: 18-26) and Booth (forthcoming, 2000).

[9]Data from the Central Board of Statistics (1999: Table 3.9) show that investment in residential housing increased much more rapidly than total investment in 1995 and 1996.

Financial crises; an inevitable childhood disease of capitalism?

It has frequently been pointed out over the last two years that the Asian crisis is unusual in that it was precipitated neither by a sharp downturn in the major industrial economies (unlike the South East crisis of the 1930s) nor by large fiscal deficits (unlike many of the Latin American crises of the 1980s). The main problem in the most severely afflicted economies has been the fragility of the financial systems, aggravated especially in the case of Thailand by the policy of pegging the exchange rate to the dollar. In this sense the Asian crisis has perhaps more in common with earlier crises which afflicted the capitalist economies of Western Europe and North America in the nineteenth and early twentieth centuries and which Kindleberger has discussed at length in numerous writings. Of particular interest is the so-called Minsky-Kindleberger model which

> assumes a 'displacement' - an autonomous change in the system, or shock- that leads to a new set of investment opportunities that may go too far, producing what Adam Smith, John Stuart Mill and other classical economists called 'over trading', that sometimes leads to 'revulsion' and 'discredit'. The displacements are sometimes real- the outbreak of war, a good harvest, a bad harvest, discoveries, inventions, such a shock as the oil price hike by OPEC in 1973 or 1979. They are sometimes financial. Among financial displacements are gold discoveries, debt conversions that lower interest rates sharply and induce those with prospectively lower incomes to take greater risks in an effort to maintain them (Kindleberger 1988: 34-5).

Kindleberger has illustrated this model not just with case studies of crisis episodes in European and American economic history prior to 1940, but also with reference to the Latin American crisis of the 1980s[10]. In that context, he argues that the financial deregulation of the 1970s, carried out in a number of countries under the influence of the McKinnon-Shaw "financial repression" literature, led to excessive bank lending and ultimately to financial crash. In the South East Asian context one could argue that the displacement was due in large part to the sharp recession of the late 1980s and early 1990s in the major industrial countries which forced the

[10]For a statement of Minsky's views on financial instability see Minsky (1982). It has been argued that Minsky's views on the "endogenous fragility" of financial systems are of direct relevance to the Asian crisis (see e.g. Akyuz 1998: 35), although Minsky's own work was almost entirely based on the mature capitalist economies, especially the USA, and has been criticised in that context. Goldsmith (1982: 42) argues that financial crises "are a childhood disease of capitalism, not an affliction of old age". Whatever one's views are of this debate, Kindleberger's interpretation and development of Minsky's arguments in the context of developing capitalist economies are, I would argue, extremely enlightening. See in particular Kindleberger (1985), (1988, Part 1) and (1989, especially Chapters 2.3 and 4).

major banks in Japan and West Europe to look to Asia for new customers. American banks did not follow suit to the same extent at least partly because of the losses they had incurred during their earlier lending sprees in Latin America. The deregulation of the banking system and the liberalisation of the capital accounts of the balance of payments which had occurred in several important Asian economies over the decade from 1986 to 1996 also contributed both to the displacement and the subsequent 'over-trading'.

When a speculative boom leads to crisis and default, then a lender of last result, either national or international, is needed to restore some measure of confidence and stability to the system. Kindleberger (1988: 44-5) has some interesting observations to make on the problems which inevitably follow when the lender of last resort has to take over a large volume of assets of failed institutions. The two polar alternatives are to inflate the bad assets away or to slowly work them off the books. In 20th century Latin America, the inflation option was usually purused: Diaz-Alejandro (1985: 378) commented that in the early 1980s "Argentina seems to have taken the time-honoured route of washing out old financial mistakes via inflation", an approach which obviously favours borrowers over lenders. During the nineteenth century the Bank of England, as lender of last resort, adopted the latter course. "In the course of the various rescue operations the Bank acquired a copper works, iron foundry, coal mines, a plantation in the Caribbean, and of course all manner of failed banks, which it liquidated and sold off gradually to recover its money and shrink the money supply" (Kindleberger 1988: 45).

The work of Kindleberger and other economic historians, has produced persuasive evidence to support the view that financial crises are almost inevitable in immature capitalist economies, where governments and central banks are unable to enforce prudential regulation over the banking sector, either because they lack an understanding of how the banks they are supposed to be regulating carry out their business, or because they lack trained and honest staff to enforce regulations or because they are thwarted in their regulatory activities by powerful vested interests with strong political connections. (Historical experience suggests that a combination of all three causes is not unusual). In addition the southern cone experience of the 1980s demonstrated convincingly that a combination of preannounced or fixed nominal exchange rates, relatively free capital movements, and domestic and external financial systems characterised by various imperfections "set the stage not only for significant microeconomic misallocation of credit, but also for macroeconoic instability, including the explosive growth of external debt" (Diaz-Alejandro 1985: 377).

With all this historical experience to draw on, why were so many commentators convinced that the South East Asian economies were immune to the

kinds of financial crises which had occurred in so many other economies in the early phase of capitalist development? Clearly a comprehensive answer to this question would go well beyond the scope of this paper. But there can be little doubt that the (in my view) quite irresponsible over-hyping of the "Asian Miracle" not just by the World Bank but also by many other expert commentators in the media, in any number of academic institutions, as well as in governments and business, created a climate of manic optimism in which it was difficult for anyone who tried to raise a note of caution to get a hearing. It is easy enough now with the wisdom of hindsight to question the judgement of those bankers who lent billions of dollars to companies in Indonesia, Thailand and elsewhere whose main assets were not infrequently the political connections of their principal shareholders. But when leading economists in international institutions and elsewhere were assuring them that the party was going to last forever, could they really be blamed for their folly?

Why has the Indonesian crisis been so severe and what is the best way out?

If my description of the displacement mechanisms relating to South East Asia in the late 1980s and early 1990s are broadly plausible, then we must ask why the resulting speculative boom led so quickly to a full-scale crisis, not just in Thailand, the country where many observers were scenting trouble by late 1996, but also in Indonesia where most commentators appeared agreed that the fundamentals of the economy were "sound"[11]. There are of course a number of different diagnoses as to why the Indonesian financial system has turned out to be so fragile, ranging from pervasive cronyism in the domestic economy to the malign machinations of international speculators. My own view is that it is useful, in answering the twin questions "Why was the Indonesian crisis so severe and what is the best way out?" to look at domestic and international factors separately, both in analysing their role in provoking the crisis, and in framing sensible policies to get the economy back on a stable growth path. In what follows I will argue that Indonesians must review, and renegotiate, both the terms on which they do business with one another, and the terms on which they do business with the rest of the world. Let us look at the domestic issues first.

(a) Renegotiating the terms on which Indonesians do business with one another

One illustrious international authority has recently argued that the Asian crisis "was caused much more by under-regulation than by corruption or any other side

[11] For a not untypical statement on Indonesia's propects in early 1997, see Jay Solomons, "What Political Risk", *Far Eastern Economic Review*, February 20, 1997.

effects of an overly close relationship between business and the government" (Johnson 1998: 654-5). Johnson goes on to argue that what the afflicted Asian economies need most is "neither more nor less regulation, but effective, expert guidance of the sort Japan and South Korea exercised during their periods of high-speed economic growth". But some experienced Indonesia-watchers see the problem rather differently. Certainly there can be little doubt that the events of late 1997 were triggered by serious problems in the Indonesian financial system, at least some of which were already well-known and widely discussed. The growing scale of unhedged corporate indebtedness, the weaknesses of the domestic banking system exemplified by the high ratio of non-performing loans in the state banking sector, and the ineffectual regulatory regime all contributed to the fall in the rupiah and the collapse of confidence not just in the banking system but in the entire corporate sector in Indonesia[12].

To many observers, both in Indonesia and elsewhere, these financial difficulties reflected deeper problems of nepotism and corruption. In their comprehensive study of Indonesia's financial development, Cole and Slade (1996, Chapter 10) expressed concern over the mounting evidence of "connected lending" in the financial sector, the increasing politicization of major investment decisions and predicted that, like most other developing economies, Indonesia would at some stage face a financial crisis, whose handling would provide "an important test of how sound a structure has been created". Two years later, they wryly conceded that "these cautionary assessments proved much too moderate" (Cole and Slade 1998: 62). The rapid collapse of the Indonesian banking system in late 1997 and early 1998 necessitated huge liquidity supports from the central bank, which led to mounting inflation in the latter part of 1998. Ultimately a large part of the banking system was taken over by the Indonesian Bank Restructuring Agency (IBRA) and will have to be restructured before being sold back to domestic or foreign buyers[13]. Cole and Slade are in no doubt that the problems in the Indonesian financial system which necessitated this drastic outcome were essentially political and argued:

> The failure to put together an effective initial response and the ultimate severity of the Indonesian financial crisis must be understood and explained as the consequence of the lengthy process of politicisation of economic and financial activity within Indonesia, and the concomitant erosion of any effective prudential supervision over financial institutions by regulatory authorities, coupled with imprudent behaviour by many foreign lenders and investors (Cole and Slade 1998: 62).

[12] For a discussion of the state of the Indonesian banking system in mid-1997, see "Banking in Asia and the IMF-World Bank", *Far Eastern Economic Review*, September 25, 1997.

[13] See Pardede (1999: 25-30) for a discussion of the bank restructuring programme.

As the crisis deepened it became clear that the administration, and the elderly autocrat who led it, were more concerned with protecting family and cronies than with the health of the economy. Years of "crony capitalism" had taken a severe toll not just in terms of public confidence but also in terms of the regime's ability to respond to a serious economic crisis. The problem was not fundamentally one of incompetent regulators: there were certainly key people in both Bank Indonesia and the Ministry of Finance who were aware of the magnitude of the problems in the banking sector. But when they attempted to apply prudential rules to the lending policies of politically well-connected institutions, they were either removed from office or otherwise sidelined.

Some writers have played down the very serious cumulative effects of "corruption, collusion and nepotism" over many years, and have placed more of the blame on the IMF for aggravating, or even causing, the crisis in Indonesia. McLeod (1998: 46) for example has argued that

> The existence of anti-competitive policies designed to enrich the favoured few was deplorable, but the fact that these policies had been compatible with high growth that delivered immense material benefits to most segments of the population over long periods cannot be ignored. To put it bluntly, there is little evidence to support the view that these policies caused the crisis.

McLeod and other observers such as Radelet and Sachs suggest that Indonesia did not need to seek IMF assistance, and criticised the IMF for demanding too many structural reforms as conditions for their aid package[14]. Radelet and Sachs (1998: 22) criticised the closure of the sixteen banks in November 1997 as triggering panic, but it is probable that if no banks had been closed, many business people would have concluded that Soeharto was protecting his own family, and confidence would have collapsed even faster. Goldstein and Weatherstone (1998) argue that allowing insolvent banks to stay open in any severe crisis encourages "gambling for resurrection", which ultimately adds considerably to the cost of cleaning up the banking sector, a cost that is usually borne by taxpayers. They assert that "if there was a mistake in Indonesia, it was that the authorities did not close enough insolvent banks".

Certainly the behaviour of the IMF may not have been well judged or especially skilful: closing sixteen banks and announcing that more closures were to follow was certain to provoke a collapse of public confidence in a banking system where there were no credible government deposit guarantees. But to blame the

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[14]A similar point has been made by Lee Kuan Yew in an interview with *Asiaweek* magazine on 21 May 1999.

IMF. or any other external power for what happened is to miss the central point. The Soeharto regime finally collapsed because of its severe internal problems, and because of policy mistakes and wilful negligence, whose cumulative impact finally destroyed the credibility of the regime both at home and abroad[15].

Cole and Slade, and other writers have made it clear that increasing cronyism and nepotism went hand in hand with the decline of technocratic influence over economic management in Indonesia in the last phase of the Soeharto period. The emergence of the technocrat in South East Asia over the last three decades has been a much discussed feature of public policy-making throughout the region. By the late 1960s, "every government in Southeast Asia was authoritarian to some degree, and economic planning agencies were playing significant roles in most of them"[16]. These agencies needed economists, statisticians and demographers and (to a much lesser extent) other social scientists who could easily interact with similarly trained people in the international and bilateral development agencies who controlled the flows of aid, so important to most regimes in the region. Foreign governments and foundations made generous funding available to train young Indonesians, Malaysians, Thais and Philippino graduates in western universities, especially in the USA. As these graduates returned, often with doctoral degrees, they moved into senior positions not just in planning agencies, but in central banks, ministries of finance, other government departments, and university research centres. Some were appointed to cabinet positions, usually as Ministers of Planning, or Finance; in Indonesia, such technocrats also became at various times, Ministers of Agriculture, Health, Education, Trade, and Research. The Indonesian reliance on technocrats was indeed exceptional, but successive administrations in Thailand, Malaysia and the Philippines also appointed economists with foreign (usually American) graduate training to cabinet posts. In virtually no case did these appointees have to go through any form of electoral process.

To some foreign observers, this reliance on technocrats suggested that the ASEAN countries were following the "East Asian" model of the strong developmental state, derived from the experience of Japan, South Korea and Taiwan. This model emphasises the high degree of autonomy enjoyed by key decision-makers, especially in the bureaucracy. As Chalmers Johnson has argued in the context of Japan, the government "displays the usual qualities of an Asian kleptocracy only in its ruling party, but the party's functions in the Japanese system

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[15]MacIntyre (1998: 8) argues that critics of the IMF certainly overstate its role in aggravating the crisis; he points out that the "real culprit was the Indonesian government's own awful mishandling of the crisis", and this was ultimately rooted in the country's "extraordinarily centralized political system". I agree with this diagnosis.

[16]Bresnan (1993), p. 72.

are to reign, not to rule. The latter is entrusted to an elite officialdom"[17]. Was it really the case that such insulated bureaucracies "ruled" in South East Asia in the decades of rapid growth? How autonomous were the central banks? Certainly the Bank of Thailand has enjoyed a considerable, albeit fluctuating, degree of independence over several decades and its technocrats were crucial in maintaining a stable monetary and fiscal policy regime through Thailand's years of accelerated growth. In Thailand, Indonesia and Malaysia, technocrats in the Ministries of Finance also had considerable success in insulating key areas of macroeconomic policy-making from overt political interference[18]. In Thailand and Indonesia, for example, the administration of duty drawback schemes, crucial to the rapid growth of a number of export-oriented industries, were placed in the Ministries of Finance to minimise corruption and malpractice[19].

Others writers suggested that the states of South East Asia comprise an intermediate case between the strong developmental states of Northeast Asia (Singapore would certainly have to be included in this group) and the notorious 'klepto-patrimonial" regimes of Africa such as Nigeria or Zaire[20]. Their governments did not appear to be hopelessly captured and corrupt, but on the other hand they were frequently beholden to sectional interest groups, and tainted by nepotism and cronyism. Nevertheless the Malaysian, Thai and Indonesian governments clearly were capable of coherent policy formulation and implementation in the face of external shocks, and were able to maintain the momentum of growth over several decades. In this they ressemble Taiwan and South Korea to a greater extent than regimes in other parts of the developing world.

If this analysis is accepted, we have to ask what then went wrong in the 1990s? A leading Thai economist has argued that the power of the technocrats over macroeconomic policy in Thailand was strongest when army governments were in power:

> whenever the army's power waned, the power of the technocrats would go into eclipse. Because of the need for patronage on the part of the elected politicians, technocrats began to have an adversial relationship against

[17] Johnson (1995), p. 68.

[18] See Warr and Bhanupong (1996) who discuss the role of the Bank of Thailand: Pasuk (1992) examines the interaction between technocrats and business leaders in economic policy-making in Thailand in the early 1980s. See also Jomo et al (1997) who examine the role of the bureaucracy in Malaysia. Bresnan (1993) Chapter 3 and Cole and Slade (1996), Chapter 10, discuss the role of technocrats in economic policy-making in Soeharto's Indonesia.

[19] Yoshihara (1994), Chapter 18 contrasts the performance of the bureaucracy in Thailand and the Philippines after 1960, and concludes that in Thailand government interventions were far more pro-market and supportive of rapid capital formation in the private sector than in the Philippines, especially in the martial law era.

[20] Macintyre (1994) develops this argument further.

> them. and naturally sought the army as allies to push their case and to protect them[21]

Professor Siamwalla goes on to argue that the "quality and competency of the Thai civil service has been declining. precipitously during the last decade". and this has inevitably affected the formulation and implementation of macroeconomic policies. The Bank of Thailand. usually considered among the more independent of the Asian central banks. and certainly a bastion of probity within the Thai financial system. was also the object of increased political interference. Governors began to be dismissed by the Minister of Finance during the 1980s. which inevitably led to collusion between Governors and Ministers of Finance to minimise conflict over policy objectives[22].

In Indonesia also. the influence of the economic technocrats who had been so influential from the very beginning of Soeharto's new order regime. appeared to be on the decline by the early 1990s. although the reasons were quite different from Thailand. Whereas in Thailand. elected politicians trooped in and out of the key offices of government in the latter part of the 1980s and the 1990s with increasing frequency. and with only sporadic attempts by the military to interrupt their progress. in Indonesia power became ever more concentrated in the president. A key turning point was the announcement of the cabinet after Soeharto's re-election for a sixth term as President in 1993. To many observers the role of the Minister of Research and Technology. Dr Habibie. seemed stronger and that of the economists much weaker (Hill 1999: 74-5). Dr Habibie was. by the early 1990s. well-known for his scepticism about "orthodox" economics and his enthusiasm for spending large sums on ambitious technology projects such as the State Airplane Enterprise in Bandung. Certainly he had a close relationship with President Soeharto. and during the years from 1993 to 1997 had some highly publicised battles with the Minister of Finance (Mar'ie Muhammad) over his spending plans. But however great his influence with the President was. it was also becoming increasingly clear that an ageing President with almost three decades of service behind him. was paying less and less attention to any member of his cabinet. By far the most influential people were his immediate family and a small group of their business associates. Cabinet ministers challenged the wishes of the first family and their courtiers at their peril. Most preferred not even to try. but rather to get on with the lucrative business of building up personal fiefdoms in whatever part of the governmental system they controlled.

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[21] Ammar Siamwalla (1997). pp. 6-7

[22] For further discussion of the decline in the influence of technocrats in Thialnad see Pasuk and Baker (1998). pp. 318-20. They pointed out that by the mid-1990s. the posts of finance minister and central bank governor "offered only temporary employment. Many good candidates were not keen to apply".

Soeharto made a last-ditch attempt to use his technocrats to stave off economic disaster in the aftermath of the Thai devaluation, but ultimately to no avail. In fact it appears that the technocrats, especially in the Ministry of Finance, used the opportunity of the first IMF agreement to insert conditions concerning deregulation of the "real" economy, especially the abolition of state and private monopolies and other perquisites of the Soeharto family. A prominent Indonesian economist has argued that such measures were "voluntarily proposed" by the technocrats to increase the credibility of the package, both to the Indonesian public and to the international markets[23]. Needless to say, Soeharto was having none of this. So what the technocrats feared in fact came true. No longer were hard times making for good policies: on the contrary by the end of 1997, "Indonesia was entering dangerous and uncharted waters" (Macintyre 1999: 153). The extreme centralization of power under Soeharto had produced a situation where no other political player had any authority to countermand his decisions or implement policies other than those which the President wanted. And by the end of 1997 it was clear that what the ailing President wanted was to protect the business empires of his family, rather than to deal with the pressing problems of the national economy.

It has been argued that it was a fundamental error to deregulate the financial system "in the context of deeply entrenched patrimonial state structures" (Pincus and Ramli 1998: 732) and that whatever government emerges after the June 1999 elections must give priority to political reform before embarking on further deregulation of the economy. On the other hand, it is clear that the state banks, whose relative size diminished as a result of the banking reforms of the late 1980s, still accounted for a disproportionate share of the bad debts of the banking system in 1999 (Pardede 1999:26). Had there been no reforms, the post-crisis problems of the banking system could well have been much worse. But can be little doubt of the need now to prioritize such political reforms as placing a limit on the Presidential term of office.

Political and constitutional reforms are a pre-condition for the development of a culture of democratic accountability in Indonesia, whereby strong independent regulatory and audit agencies can police not just the financial sector but also government departments and state enterprises. I have already argued, in the context of the financial sector, that the problem was not so much inadequate or incompetent regulation, but rather a political system which marginalised the regulators and deprived them of any effective role. Similarly Indonesia does possess a State Audit Board which has, on paper at least, considerable power to

[23]Hadi Soesastro and M. Chatib Basri (1998), p. 16. For a very similar argument in the context of South Korea, see Wade (1998), p. 12.

police financial management in both line departments and state enterprises. The real challenge will be to make these institutions more autonomous and powerful.

There has been much talk about the need for "meaningful political and economic decentralisation" since Soeharto's departure, especially in the light of the widespread fear that greater openness and democracy may in fact lead to the break up of the country, as happened in the former Soviet Union. Thus in April 1999, the outgoing parliament pushed through a law which allows provinces to retain a greater share of the revenues generated from their resource wealth. More such legislation will doubtlessly be demanded in the new parliament[24]. But devolving revenues and decision-making to provincial and local authorities is no guarantee that corruption will be eliminated or that the funds will be used more efficiently in sectors such as health and education where there is an obvious need for greater provision of basic services. A culture of both political and financial accountability must be developed at all levels of government and this will take time to evolve.

(b) Renegotiating the terms on which Indonesia does business with the rest of the world

Many observers in the international media and elsewhere have tended to see the crisis in Asia as the inevitable consequence of the headlong rush towards globalisation, especially of capital markets, which is alleged to have been a special feature of the world economy in the 1980s and 1990s. For those who argued in the 1970s that the world economy was dominated by the industrial economies, that trade and investment links with the periphery were always exploitative, and that the interests of the periphery would be better served by "delinking", the current crisis is viewed as confirmation of their old fears. But the older "delinking" school differed from later critics of globalisation in that they tended to view the current growth of world capital markets as a continuation of a much longer-term phenomenon, starting according to some authors in the sixteenth century or even earlier. But both sets of writers imply that world trade and capital flows have always been conducted on terms which are disadvantageous to the poor "south", and the current crisis is just one more manifestation of this.

Orthodox economists have tended to take a dim view of the de-linking school's arguments, but economic historians have, on the whole, been more tolerant[25]. Certainly I would argue that those economists who adhere to the so-called "Washington consensus" as a recipe for development success have some tricky historical problems to cope with. In my recent study of Indonesian economic

[24]For an analysis of these laws see Booth (1999), and John McBeth, "Too Little Too Late", *Far Eastern Economic Review*, May 13 1999

[25]See Diaz-Alejandro (1978) for a lucid and balanced review of the arguments in the context especially of Latin America.

history. I pointed out that as far as macroeconomic policy is concerned. the colonial government in Indonesia was a prominent exponent of the Washington consensus for much for of the period from 1870 to 1930[26]. There was an open capital account. the exchange rate was in effect pegged to gold through the link with the Netherlands guilder. government budgets were usually balanced and the balance of payments was often in surplus. These policies did produce some GDP growth especially in the decades from 1900 to 1930[27]. But they did not lead to a sustained process of economic development and transformation as happened in Japan over the same period. I discuss the reasons for this failure in more detail in my book: I should add that I do not think that one can simply blame "colonialism" for Indonesia's failure to develop because Thailand pursued much the same kinds of policies over the same period. was not a colony. and did not succeed in emulating Japanese achievements either[28].

These puzzles raise important issues in the comparative economic history of South East Asia which cannot be pursued here. A crucial lesson seems to me to be that "sound" macroeconomic policies may be a necessary but they are hardly a sufficient condition for sustained economic development. Furthermore some aspects of the "Washington consensus" policy package may not be optimal for relatively small. open low and middle income economies struggling to achieve the twin objectives of rapid growth and domestic price stability in a world where cross-border capital flows are growing rapidly. This applies especially to complete convertibility in the capital account: there has been a spate of articles over the past two years from eminent economists which question the wisdom of this policy for most. if not all. developing economies[29]. As Diaz-Alejandro pointed out with reference to the Latin American crisis of the early 1980s. unrestrained convertibility was not the expectation of the architects of the Bretton Woods system: it has only became part of the dogma of the IMF and the World Bank

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[26]See Booth (1998). pp. 11-12. For an elaboration of these arguments in a comparative context. see Alam (1998).

[27]They also led to substantial inflows of foreign investment. It is worth bearing in mind that the total stock of foreign capital in South East Asia in 1937 was almost certainly larger in real terms than in 1975. In per capita terms several countries in the region had lower stocks of FDI in 1989 than in the latter part of the 1930s (Philippines. Burma. Vietnam). So the impact of globalisation. at least as it has affected FDI inflows. has been far from uniform across the region. and indeed was almost certainly more important in some parts of South East Asia in the 1930s than more recently. See Lindblad (1998). Chapter 2.

[28]Feeny (1998) gives a very useful overview of the literature on the issue of why Japan moved ahead while Thailand stagnated. He places much emphasis on the more favourable initial conditions in Meiji Japan. especially a regime of property rights which facilitated both physical and human capital formation. In Thailand education lagged behind Japan. and the institutions were less adapted to the requirements of modern economic growth.

[29]See in particular Stiglitz (1998) and Bhagwati (1998).

more recently[30]. It is a dogma that most developing countries, in South East Asia and elsewhere, would probably be wise to ignore.

I do not think that the answer lies in draconian controls on capital movements: where these have been tried in porous South East Asian economies, they have usually failed. Much progress was made over the years from 1985 to 1995 in reducing controls on foreign direct investment inflows into Indonesia, and it is difficult to see what could be gained from restoring such controls. The policy challenge is surely to develop policy tools to prevent destabilising speculative flows. Controls on the inward flow of long-term investment capital could only damage economic recovery by deterring new investment and encouraging established investors to leave. The new cabinet of President Wahid in fact includes fewer "economic nationalists" than the last two Soeharto cabinets, and the new Co-ordinating Minister for the Economy, Finance and Industry, Kwik Kian Gie, is known to be extremely keen to attract more foreign investors into Indonesia.

If there are no sound arguments for imposing more controls on long-term capital inflows, neither in my view is anything to be gained from a return to extensive trade protection, and a trade, taxation and exchange rate regime which penalises exporters and subsidises import-substituting industry. There is plenty of evidence that such a regime has been responsible for a good part of the inequitable distribution of income between urban and rural areas in many parts of South East Asia for the last four decades, and indeed longer. The policy reforms in Thailand, Indonesia and Malaysia over the 1980s which reduced or abolished export taxes, and removed at least some of the disincentives to export have together been hugely beneficial to the working poor in these countries. Much more could be done to level up the playing field for different categories of producer and worker but to return to the kind of regime which prevailed in Indonesia in the early 1960s would be a tragedy.

There has also been much discussion since the crisis erupted of policies involving the imposition of a currency peg, together with exchange controls. I would argue that they should be resisted. Such policies would in the longer term almost certainly lead to an overvaluation of the currency, and thus amount to a tax on producers of traded goods, the very people who must be relied on to spearhead an economic recovery. The re-imposition of exchange controls, abandoned in most economies in the region by the late 1960s would also lead to a resurgence of the black markets and smuggling. This in turn would create new opportunities for corruption and rent-seeking even as the new government in Indonesia has to cope with the bitter legacy of past years. Exchange controls will also deter long-term investors, and may encourage investors already in the country to pack up and

[30]Diaz-Alejandro (1985), p. 383.

leave[31]. There is already evidence that they are having that effect in Malaysia, and the government there is now rethinking its policy.

It seems to me that the key problem for Indonesia, as for so many other small, open, developing economies is to ensure that the gains from participation in the international economy are used to accelerate the pace of domestic economic development. This can best be done through government policies which ensure that producer incomes are taxed equitably, and that the tax revenues are used for productive purposes such as infrastructure development, education and health care. However critical one might be of Soeharto's policies especially in the final decade of his period in power, it has to be conceded that over the oil boom years, the Indonesian government did a reasonable job both in securing a large part of the rents from petroleum export for the national budget (in contrast with Brunei for example, or some of the gulf states), and in using the budget revenues for much needed infrastructure development and for greatly accelerated expenditures on health and education. These policies set the scence for the structural transformation of the Indonesian economy which took place over the two decades from 1976 to 1996, and which have been much studied by numerous scholars. However much anger is currently being directed at Soeharto and his family, these policy lessons should not be overlooked.

The consequences of greater democracy for economic policy-making

It is an indication of how much opinion in and about Indonesia had changed by mid-1998 that democratization was seen by many as a necessary condition for economic recovery, rather than as a threat to continued economic growth. Writing as late as 1994, a political scientist with long experience in Indonesia pointed out that in claiming that "democracy, growth, and unity in countries like Indonesia are probably in principle compatible", he was going against the "scholarly consensus to the contrary" (Liddle 1994: 255). But that scholarly consensus has now fragmented. While there may still be some, both in Indonesia and abroad, who would argue that such a huge and diverse nation can only be held together by some form of authoritarian government, many others now realise that it is only by widening the basis of popular support that regime legitimacy can be established, and that only a government with such legitimacy can push through the formidable agenda of economic and social reform that Indonesia needs in order to return to sustained economic growth. Most surprising of all, it appears that at least some in the armed forces now think along these lines.

The change of heart on the part of the reformers within the armed forces is no doubt based on a genuine conviction that the doctrine of "dwifungsi" is now in

[31]See *Far Eastern Economic Review*, March 18, 1999, p. 61.

need of substantial revision. This doctrine provided the justification, and legitimation, for the extensive involvement in government at all levels by members of the armed forces in the Soeharto era. Indeed it was part of the rhetoric of the New Order, heavily promoted by both military and civilian officials and ministers, that the period of parliamentary democracy in the 1950s had led to factional infighting, and economic mismanagement, and that a return to that form of government would be incompatible with the goal of sustained economic development. This view overlooked the fact that the consequences of economic mismanagement were much more severe after 1957, when parliamentary democracy was jettisoned and Soekarno returned to the 1945 constitution. But it has to be conceded that for the first part of the New Order, there was widespread agreement, at least among the urban middle classes, with the view that political freedoms should be subordinated to accelerated economic development[32]. Only when the abuses of power by Soeharto and his family, and by other government officials became more flagrant did this consensus begin to break down.

There has also been, over the 1990s, a process of re-evaluation of the parliamentary period by both Indonesian and foreign scholars[33]. This has led to a better understanding of both the successes and failures of the years from 1950 to 1957, not just in economic policy, but also in the political and the constitutional arenas. I have argued that, as far as economic policy-making was concerned, the real problem in those years was not the lack of able ministers and technocrats, but rather the political instability which prevented any continuity of policy-making (Booth 1998: 62-3). If such instability returns with a more democratic system of government in Indonesia, there could be negative consequences for economic policy-making, as indeed Siamwalla (1997) has pointed out in the case of Thailand. It can of course be argued that the New Order era suffered ultimately from too much stability, and that this led to the entrenchment of patronage networks throughout the entire government apparatus which in turn caused much of the corruption and the abuse of power. Clearly there has to be some compromise between the need for policy continuity on the one hand and the need for more honest, open and accountable government on the other.

Substantial devolution of power may be one way to achieve both these goals, but it would certainly be naive to see decentralisation in itself as the cure-all for the nation's ills. Certainly the Brazilian experiences of the last two decades must

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[32]See Liddle (1992), pp. 181ff. Liddle makes the point that, to many of the key military figures in the New Order, there was no real distinction between the parliamentary and guided democracy periods. Rather they viewed the entire period from 1950 to 1965 as having "an underlying continuity in the pattern of intense, mass-based political conflict that led ultimately to the assassination of six senior army generals in 1965".

[33]See in particular the valuable collection of papers in Bourchier and Legge (Editors)(1994).

give pause for some concern. Brazil is of course well-known for achieving rapid GDP growth over the decades from the 1940s through to the 1970s; by 1980, per capita GDP had almost caught up with that of its southern neighbour, Argentina (Sheahan 1987: 181; Werneck 1994: 130). Economic growth slowed drastically in the 1980s, and greater fiscal discipline combined with substantial decentralisation were viewed as the key policies in engineering a return to growth. Unfortunately these goals proved, to a considerable extent, to be contradictory. Fiscal cuts led to a sharp fall in the real value of government salaries, while government instability meant that ministers changed rapidly:

> As ministers tumble one after another in the wake of unsuccessful stabilisation programmes, both the new minister and the people whom he tries to attract to work with him know that he will not last long, probably a few months. Assembling a competent economic team under such conditions becomes exceedingly difficult. Added to that is the fact that the mediocre team that he will finally be able to form will only make his fate more hopeless from the outset (Werneck 1994: 137).

The 1988 constitution in Brazil led to substantial fiscal devolution, but sadly this contributed to, rather than ameliorated the problems set out above

> The central government has lost a substantial part of its tax revenues to states and local governments, without being able to transfer to them any significant part of its spending programs. Nevertheless, as the new fiscal system is being phased in, states and local governments are not only quickly adjusting their spending in response to their fast-growing revenue, but are spending well above their recently enlarged means (Werneck 1994: 139).

I am not quoting these rather dismal examples in order to argue against either constitutional change in favour of greater decentralisation in Indonesia, or greater devolution of taxing and spending powers. I have consistently argued in favour of both in the Indonesian context for many years. Indonesia in my view must implement such reforms over the next few years if it is to survive as one country[34]. But it would be idle to pretend that this reform strategy is without dangers, and there are lessons which should be learnt not just from Brazil but from other parts of the world. We all know the saying that those who do not learn from history are condemned to repeat it. It would indeed be a tragedy if Indonesia repeated the mistakes which have been made in numerous well-intended democratic reform

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[34]See Booth (1996). Other papers in this volume examine issues of regional development and fiscal equity in the context of China, South Africa, the Russian Federation and India.

programmes in all too many countries over the past two decades. Learning these lessons, and implementing reforms which can solve Indonesia's existing problems without creating new ones, will indeed be a challenge for the new administration of President Wahid and for those which follow.

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